Wall Street Already Finding Loopholes in Financial Reform Legislation

Continuing in the tradition of watered down, pro-corporate legislation that the Obama administration is becoming infamous for, new reports are surfacing that banks and financial institutions may continue to get away with the same risky trading and investment practices that landed us in a recession.

Like the watered down health care reforms, or the pathetic Credit Card Act, the recent Dodd-Frank financial regulations signed into law by Obama are quickly showing themselves to be more or less useless for American workers.

The Volcker Rules:

The Volcker Rules, intended to accompany the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, comprise a list of restrictions on large financial institutions intended to help prevent a repeat of the 2008 financial collapse.

Only a handful of Paul Volker's recommendations, however, were incorporated into the final legislation.

Of the rules that were finally adopted, one in particular prohibits banks from making proprietary trades – meaning using the bank's own assets for speculative investments. This would stop banks from taking customer deposits, turning around, and using them to invest in risky financial instruments, such as the short-term trading of asset backed securities.

Proprietary trading was singled out as a major policy concern following the financial crisis because it is considered by many economists, including five former Secretaries of the Treasury, to have been one of the leading contributors to the 2008 economic crash. Proponents of the ban argue that by allowing banks and financial institutions to engage in proprietary trading, we were providing bankers with the means to continue funding absurd loans and risky investments.

Mortgage backed securities (MBS), in particular, are considered to have financed much of the risky lending which led to the collapse.

Creating a bubble:

The concept behind MBS's was straightforward: instead of selling single mortgages on their own, which isn't very attractive to large financial institutions, banks would stick hundreds and thousands of mortgages together into a single package and sell them together. These large securities would offer investors much higher profits, and also make mortgages easier to finance – even if one of the mortgages fails now, there are still five hundred others producing a return.

This, in turn, encouraged banks and mortgage companies to sell more mortgages – even to people who normally would not be able to afford them.

As more mortgages were sold, the value of homes in the market skyrocketed, producing more money with which banks could then go out and finance more sales of homes.

So, when the housing bubble finally burst, and the value of millions of homes across the country plummeted, banks and financial institutions lost billions, leading to the recession we are in today.

The reforms failure:

Banks such as Goldman Sachs, JP organ Chase, and Morgan Stanley are poised to take advantage of the new regulations by using gaping loopholes left in the legislation.

Although the language of the new rules stipulate that these banks can no longer make short-term trades of securities for their own account, it turns out there is nothing in the legislation which prohibits them from trading the same securities (what they call "principal investments") on a longer term basis.

Whats more, even the prohibition of trading short-term securities may be avoidable.

Author Michael Lewis notes,

The Dodd-Frank bill bans proprietary trading… and then appears to make it clear what that means (Page 565: "The term 'proprietary trading' means the act of a [big Wall Street bank] investing as a principal in securities, commodities, derivatives, hedge funds, private equity firms, or such other financial products or entities as the comptroller general may determine").

"The big invitation for abuse," Lewis continues, "lies in the phrase 'as a principal.'"

It is likely, in fact, that many firms will simply skirt the issue of being a principal investor or not by always claiming that their proprietary investments were done at the request of a client.

Former Lehman Brothers corporate bond salesman Robert Wosnitzer notes that during the process of researching the history of proprietary trading, "[One] trader I interviewed said that from here on out, if he wants to take a proprietary position in a credit, he will argue that he bought the position because a customer wanted to sell the position, and he was providing liquidity…"

"There are a hundred different ways to claim to be acting as an agent or for a customer." Says Bloomberg's Micheal Lewis. "This ambiguity is no doubt one reason the financial reform bill passed in the first place. Even its clearest prohibitions are couched in language inviting Wall Street to evade them."

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